

Use of Tax and Non-Tax Policy to Influence "Timber Liquidation" and Short-Term Speculation in Timberland and Timber

A Brief Analysis of State-Based Policy Options

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I. INTRODUCTION

This analysis is prepared at the request of the Maine Forest Service. The objective was to evaluate the extent to which other state governments have used tax or other policies to create disincentives to "timber liquidation", and to offer some observations on the applicability of these or other possible approaches in the State of Maine.

For the purposes of this analysis, "timber liquidation" is defined as:

The purchase of timberland (often highly leveraged), followed soon thereafter by the removal of most or all commercial value in standing timber, and subsequent attempted re-sale of harvested land, typically within a period of one to five years.

For the purposes of this analysis, "timber liquidation" does not mean timberland that is subject to heavy harvesting and remains under the same ownership for some time after harvest.

Timber liquidation is generally viewed as inconsistent with accepted principles of "forest stewardship" or "sustainable forestry". It often leads to indiscriminant harvest; it is often a speculative practice that can lead to volatility in timberland prices and hasty land subdivision; and it is characterized by careless eventual disposition of timberland with little regard to its ultimate use. As a general business practice, however, timber liquidation has occurred for decades, if not centuries, in northern New England. As long as there is money to be made from the purchase, quick monetization of timber value, and subsequent re-sale of timberland, there will be individuals and companies involved in this practice.

The key to influencing the extent of timber liquidation through public policy lies in fundamentally altering the profit assumptions of those who engage in this practice. Discussion over how to accomplish this, without penalizing responsible forest landowners, has been the subject of increasing forest policy debate in northern New England. Whether or not this is possible through the implementation of state or local tax or other policy is a matter of conjecture since, as the ensuing analysis shows, there is almost no experience in other states to evaluate.

¹ P.O. Box 1767, Hillsboro, NH 03244. (603) 529-0221. Under no circumstances does Innovative Natural Resource Solutions endorse or imply endorsement of any of the options that are discussed in this analysis.

II. PUNITIVE TAX POLICY

1. Imposition of a Land and Timber Gains Tax

A Westlaw legal search² of state statutes was conducted to determine which states have enacted short-term gains taxes or other tax policies as a disincentive to timberland speculation and/or timber liquidation. We also ran an extensive Internet search for relevant databases and articles. Our searches revealed that only the state of Vermont has implemented a land and/or timber gains tax. We also conducted interviews with several prominent forest tax policy experts³, none of whom were aware of any states that had enacted land or timber gains taxes or other policies specifically designed to curb timber liquidation, with the exception of Vermont.

Vermont enacted its land gains tax in 1973⁴. The constitutionality of this law has been challenged and upheld on at least two occasions (*Langrock v. Vermont Dept. of Taxes* [1980] 139 Vt. 108, 423 A.2d 838, and *Chamberlain v. Vermont Dept. of Taxes* [1993] 160 Vt. 578, 632 A.2d 1103).

Vermont's is a graduated tax specifically designed to deter short-term high-profit transactions. Initially the law applied to land sales only. In 1995, in response to several notable forest land transactions in Vermont, the legislature amended the statute to include the sale of timber or rights to timber. The gain from the sale of timber or timber rights is combined with the gain or loss on the sale of the underlying land to determine the gains tax liability. The gains tax on timber income is only triggered if the underlying land is sold within six years of purchase. There is no gains tax liability if the forest land is enrolled in the Vermont use value taxation program and has a qualifying forest management plan under that program. Further, this provision of the law applies only to individual contiguous tracts of greater than 300 acres in size.

According to Bob Gross, Income Tax Analyst with the Vermont Department of Revenue⁵, only three or four sales have been subject to a gains tax liability under the 1995

² Conducted by David Harrigan, Esq., Kidder & Upton, PA, Laconia, NH. See Appendix A.

³ Personal communication (June 24 through July 3, 1996) with Deb Brighton (Ad Hoc Associates, Norwich, VT), Joan Youngman (Lincoln Institute of Land Policy, Cambridge, MA), William Siegel (ret. U.S. Forest Service, River Ridge, LA), John Greene (U.S. Forest Service, New Orleans, LA), Scott Berg (AF&PA, Washington, D.C.), Karen Elsen, (Forest Industries Council on Taxation, Washington, D.C.), Lester DeCoster (The DeCoster Group, Reston, VA), Dr. William Hoover (Purdue University, West Lafayette, IN), Dr. Paul Ellefson (University of Minnesota, St. Paul, MN), and Dr. Keith Argow (National Woodland Owners Assn., Alexandria, VA).

⁴ For more information on the Vermont Land Gains Tax, see brief analysis by Charles R. Niebling and Charles A. Levesque, Innovative Natural Resource Solutions, prepared for Maine Forest Service, June, 1996. An excellent and very thorough analysis of the effectiveness of this tax is: D. Robinson and E. M. Chant. 1992. Interaction of Land Policy and Land-Based Tax Policy: The Vermont Land Gains Tax. Review of Urban and Regional Development Studies 4(2).

⁵ Personal communication, June 26, 1996

timber amendment. He would not offer any observations on how effective the law has or has not been at deterring timber liquidation. Jim Shallow, Forest Policy Analyst with the Vermont Natural Resources Council⁶ said that the law is largely ineffective, because the majority of timber liquidations in Vermont occur on parcels that are less than 300 acres in size. He suggested that two improvements to the law that might make it more effective would be to drop the acreage threshold to 100 acres, and increase the maximum holding period within which a gains tax may be levied from the current 6 years to 10 years.

A forester with a large timberland investment firm active in northern New England, including Vermont, felt that the marketplace has already adjusted for the imposition of this new tax in Vermont. (In their analysis of the Vermont Land Gains Tax, Robinson and Chant⁷ state: "Early results of the Vermont land gains tax raise an interesting question: did the tax have one-time effects only, after which the market, including the land speculators, adjusted to the new cost and built the tax into the price of land?"). The timberland investment forester speculated that market conditions for timber are a much more significant factor than the gains tax in influencing the extent of timber liquidation-type sales.

For such a tax to effectively curb timber liquidation, it must be high enough to fundamentally alter the economic assumptions of the purchaser, before purchase. The Vermont tax starts at a high of 80 % of profit, if the land is sold within 4 months of purchase, and the gain is 200 % or more of the cost basis. Most timber liquidations and subsequent re-sale would be expected to take place within one to five years after purchase. Gains from the re-sale of typical timberland would not be expected to be as high as those from land with high development potential. If we assume that typical gains from timber liquidation (including the gain from timber income and land income combined) may be in the range of 10 % to 40 %, and occur within 1 to 5 years after purchase, then the tax liability based on Vermont's graduated scale would be 10 to 25 % of the gain. If the buyer purchases the land at a time of poor market conditions for timber, then waits for market conditions to improve, increases in stumpage value may be enough to partially offset a tax of this magnitude. In the last several years, Northern New England has experienced upward and downward market price fluctuations for certain species of timber in the range of at least 10 to 30 %.

Some parcels that are purchased with the intent of quick liquidation of timber and subsequent re-sale are often held by the buyer indefinitely. Low property taxes, such as those under New Hampshire's current use program (which has no management requirement, and does not restrict clear-cutting as a condition of qualification), enable the owner to hold the land beyond the period in which a graduated gains tax might be triggered (see section IV).

⁶ Personal communication, July 2, 1996

⁷ D. Robinson and E. M. Chant. 1992. Interaction of Land Policy and Land-Based Tax Policy: The Vermont Land Gains Tax. In Review of Urban and Regional Development Studies 4(2), pp. 147-161.

A variant of the Vermont land/timber gains tax for Maine to consider would simply be to have the tax levied on timber income only. This concept is discussed in the next section.

2. Graduated Timber Severance Tax

Several states (e.g. NH, WA, CA, NY, WI, GA) have enacted timber severance or yield taxes, either as an alternative to annual property taxation of timber or as an additional tax on timber. These taxes were never intended to create disincentives to timber liquidation *per se*; rather, many were enacted to provide incentives to landowners to grow timber to maturity, by taxing timber at the time of harvest when income from the investment is generated, rather than annually based upon the appreciating value of growing timber, when no income may be expected for years or even decades.

In New Hampshire the yield tax (NHRSA 79) is levied at the time timber is harvested, and equal to 10 % of the fair market stumpage value at the time of harvest. Timber is theoretically exempt from annual property taxation: the state's current use taxation law (NHRSA 79-A) includes a deduction for timber tax in the capitalization formula for determining annual forest valuation.

The State of Maine does not currently have a timber severance tax. The Tree Growth Tax Law assesses property tax on timberland based upon the capitalized average annual value growth in timber. For landowners who are not enrolled in the Tree Growth Tax program or in Maine's alternative Farm and Open Space Tax Law, the value of timber can be presumed to be included in the *ad valorem* valuation of land for property tax purposes.

One option for Maine to consider would be a Graduated Timber Severance Tax. Under this concept, income from the sale of timber would be subject to a severance tax at the time of harvest. This tax would be graduated as a function of the length of time the land had been under current ownership; it would start high and phase out over time. For example, if a 500-acre tract is purchased in 1997 and commercially clear-cut in the winter of 1997-1998 (subject to limitations of the Maine Forest Practices Act), then the fair market value of the timber would be subject to, say, a 50 % (or higher) tax. The amount of the tax would decline quickly as a function of the length of time the land was held before timber income was generated -- after five years there would be no severance tax.

Unfortunately, such a tax would create a powerful disincentive to potential long-term timber investors. It is a common practice among many timber investors to buy timberland and conduct immediate harvests (often thinnings or pre-commercial harvests) to partially offset acquisition debt and concentrate growth on higher quality growing stock. One way to address this would be to exempt any owner who enrolls his land in the Tree Growth Tax Law from liability for a severance tax (the presumption being that most long-term investors would quickly enroll in TGT and meet management plan requirements). Most individuals engaged in timber liquidation would not be expected to enroll the land in Tree Growth Tax because of the management plan requirements and the stiff penalty for withdrawal. As mentioned earlier,

Vermont's Land Gains Tax exempts landowners enrolled in the Vermont current use program and who have a qualifying management plan.

A gains tax or timber severance tax will likely be met with resistance by landowners. One option for making either a gains tax or timber severance tax more acceptable would be to allocate the revenues to specific purposes, rather than to the Maine General Fund. For example, revenues could be dedicated to forest policy needs, such as data collection, forest health and biodiversity monitoring, ecological reserve acquisition, or purposes of particular interest to landowners, such as the Service Forester program. The severance tax could be administered by municipalities (as it is in NH) and revenues could be received by them.

One note of caution: a severance tax is difficult to administer and assess. New Hampshire's experience indicates that without strong and equitable enforcement, such a tax is vulnerable to under-reporting and fraud.

III. PUNITIVE NON-TAX POLICIES

1. Licensed Forester Requirement Under Certain Circumstances

Anecdotal observation suggests that most individuals engaged in timber liquidation do not retain the services of a professional licensed forester. One potential disincentive to liquidation would be to prohibit a landowner from harvesting timber in circumstances not otherwise regulated by the Maine Forest Practices Act (current or future) within, say, three years after acquisition, without first retaining a licensed forester to prepare a management plan subject to state review (or approval, subject to criteria defined by statute or rule). Some disincentive would come in the costs associated with this requirement. More importantly, however, few licensed foresters who value their reputations would wish to be associated with timber liquidation activity, making it difficult for the landowner to find a qualified individual willing to lend his or her name to the operation.

At the very least, such a requirement would create incentives for full compliance with applicable state laws. Under the Maine Forester Licensing Law the forester would assume legal responsibility for compliance (subject to contract language between the forester and logging contractor), and a law violation can lead to license revocation.

IV. INCENTIVE-BASED TAX POLICY

1. Amendments to Maine Tree Growth Tax Law

Reductions in property taxes can be a powerful incentive. Our conversations with forest tax policy experts repeatedly made reference to that fact that many states have sought to create incentives for long-term responsible forest management through their use valuation property tax programs. This is true to some extent in Maine, where the Tree Growth Tax (TGT) Law now

requires the landowner to submit a sworn statement that a forest management and harvest plan has been prepared by a licensed forester or reviewed and certified by a licensed professional forester as consistent with sound silvicultural practices (this provision adopted in 1989 as part of the Maine Forest Practices Act, but not required on all ownerships until 1999).

It is also true in Vermont, where the State Department of Forests, Parks and Recreation establishes minimum standards for acceptable forest management, reviews and approves management plans, and monitors compliance. New York's may well be the strictest of all. The New York Dept. of Environmental Conservation sometimes requires non-commercial work to be done, depending on the site and desired product. A violation penalty is levied if work is not completed according to the plan, although it is possible to amend the plan.

Other states whose current use laws include restrictions relative to forest management include California, Washington, Oregon, Wisconsin, Alabama, Massachusetts and Georgia⁸.

Compliance enforcement with the management plan requirement in Maine is minimal, in part because the requirement is relatively recent and landowners enrolled prior to 1989 were grandfathered until 1999. One option for Maine to consider relative timber liquidation would be to provide the State with new authority to certify TGT landowner compliance of harvest operations with sound silvicultural practices. Failure to comply, based upon some consensus definition of "sound silvicultural practices", could result in forced removal from TGT and liability for withdrawal penalties, or the imposition of a violation fine. Another option would be to simply require compliance with the Maine Forest Practices Act as a condition of continued enrollment in TGT. Under current law, a landowner may be in violation of the Forest Practices Act and still remain in TGT.

Maine's withdrawal penalty is stiff. Many observers feel the penalty is stiff enough to discourage speculators or would be timber liquidators from enrolling in TGT⁹. The above options would obviously not apply to landowners who have not enrolled in TGT. Most experienced timber liquidators probably do not enroll in TGT because of the high withdrawal penalties, which may be greater than paying full value property taxes for the period time they intend to hold the land. Thus, we question whether any amendments to TGT alone would create effective disincentives to timber liquidation.

2. Graduated Maine Income Tax Credit

Because Maine has a personal and corporate income tax, it may be possible to consider creating incentives within this tax to promote long-term forest management. One approach

⁸ The Final Report of the Northern Forest Lands Council Forest Taxation Project provides a good overview of current use tax programs in NH, VT, NY, CA, WI and GA. See NFLC Technical Appendix, published, February, 1994.

⁹ From analysis of Maine Tree Growth Tax Law by Ad Hoc Associates, in Final Report of the Northern Forest Lands Council Forest Taxation Project. See NFLC Technical Appendix, published, February, 1994.

would be to institute an indexed capital gains credit for income from the sale of timber or timberland. For example, if the maximum effective income tax rate on income for individuals is 8.5 % (+\$1,268.00), this percentage could be reduced by 10 % overall (or 0.85 %) per year up to a complete exemption from income tax after 10 years, thereby providing a modest incentive to retain both the land and growing timber for long periods. Because the corporate income tax rate is structured differently a different mechanism would have to be developed for corporations or other businesses subject to the tax..

This option has limited potential as a disincentive to timber liquidation because the income tax rate may simply be too low to effectively offset gains from short-term timber liquidation.

V. CONCLUSIONS

Aside from Vermont, no states have enacted tax or other policies to specifically discourage timber liquidation activity. Some states have attempted to address this problem by providing property tax incentives within their current use programs. Vermont's 1995 timber amendment to the gains tax law is simply too recent to know whether it is an effective deterrent to timber liquidation; anecdotal evidence from Vermont suggests that it may not be.

Based upon this brief analysis of policy options, we believe some combination of a gains tax on land and timber, and/or a graduated timber severance tax may be the most effective deterrents to timber liquidation. Tax rates must be high enough to significantly change the profit assumptions of the would be liquidator. This policy must be carefully structured to account for potential loopholes, and to avoid penalizing long-term investment and management.

It may be difficult to determine the effectiveness of such policies, because of the complexity of separating the general effects of a cyclical timber economy and unpredictable federal tax policy from the effect of a state gains or timber severance tax. As one author recently noted: "The unfortunate conclusion is that the weight of the evidence suggests that efforts to control speculative volatility with holding taxes, short-term gains taxes or simply with transactions taxes have not been successful. It may well be that the potential gains to holding leveraged assets during boom periods are so great that even high rates of taxation do not discourage people from jumping in."¹⁰

A land and timber gains/severance tax will undoubtedly be met with stern resistance, not only by those who engage in timber liquidation, but also by many conscientious timber investors. Such policies will be viewed by some as confiscatory, and would likely be challenged legally (the constitutionality of Vermont's Land Gains Tax has been upheld). The State of Maine must be convinced, and be prepared to provide evidence to demonstrate unequivocally, that timber liquidation is a serious enough problem that it warrants the adoption of such policies.

¹⁰ Case, K.E. 1992. Taxes and Speculative Behavior in Land and Real Estate Markets. In Review of Urban and Regional Development Studies 4(2), pp. 226-239.

Finally, while the focus of this brief analysis was potential state policy options, we would be remiss if we did not reinforce the importance of federal tax policies. Restoration of a capital gains differential for timber income has been a goal of private timberland policy advocates since its repeal in 1986.

Estate tax caused-liquidation may well be major driver behind timber liquidation in Maine, as it is throughout the country¹¹. Landowners over 65 years of age hold 25.6 % of Maine's non-industrial private forest land¹². Unless steps are taken to reduce the estate tax liability of heirs upon inter-generational transfer of a forest ownership, post-probate forced liquidation and conversion of timberland will undoubtedly continue.

¹¹ DeCoster, Lester. 1995. Maintaining the Public Benefits of Private Forests Through Targeted Tax Options. Published by American Forests, Forest Policy Center. 75 pp.

¹² 1995 data. Personal communication with Thomas Birch, Resource Analyst, U.S. Forest Service, Northeast Forest Inventory & Analysis Unit, Radnor, PA, July 9, 1996

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July 7, 1996

Mr. Charles Niebling
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Re: The Compact for Maine's Forests

Dear Charlie:

This is my report on using legal research tools to find state statutes similar to Vermont's anti-speculation land gains tax. I found none.

I used the Shepard's service to locate every published state and federal court decision which has mentioned the Vermont statute. I read every case in the list, but none mentioned any similar law in another jurisdiction.

West Publishing Co. has assigned "key numbers" to virtually every legal topic to assist in research using their publications. The key number for state taxes on gains from the sale of property is Taxation 996.1. I found no cases under that number that mentioned any other anti-speculation law.

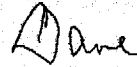
Using WESTLAW, which is the computerized research product of the same company, I entered the following search "Terms and Connectors" for the database that includes all state statutes: "land and gains and tax", wherever found in the same document. Using the "Natural Language" feature, I added: "progressive tax on gains from speculative sales of land". Twenty entries resulted. Only the Vermont statute itself was relevant.

I also searched in WESTLAW by key number for court cases in any state after 1991. I scanned the resulting 112 cases, but none were pertinent.

Topical searches produce many references to taxes on gains from land sales, since those gains are taxed as income in many states. Some apply only to businesses. Vermont's law is uniquely structured with very high rates for very short ownership periods, leading to no tax after 6 years. Those features are difficult to isolate in research. Only a page by page examination of the tax statutes of every state would provide certainty about the existence of a similar law.

You can confidently report that legal research by manual and computer methods yielded no references to a similar statute in any state. I'll mail you a printout of the 20 statutes and the Shepard's pages for your file.

Sincerely,

A handwritten signature in dark ink, appearing to read "Dave", written in a cursive style.

David Harrigan